

VZCZCXRO5864
RR RUEHLH RUEHPW
DE RUEHIL #3532/01 3121348
ZNY CCCCC ZZH
R 071348Z NOV 08
FM AMEMBASSY ISLAMABAD
TO RUEHC/SECSTATE WASHDC 9861
INFO RHEHNSC/NSC WASHINGTON DC
RUEKJCS/SECDEF WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHDC
RUCPDO/DEPT OF COMMERCE WASHDC
RHEBAAA/DEPT OF ENERGY WASHDC
RHMFISS/CDR USCENTCOM MACDILL AFB FL
RUEAIIA/CIA WASHDC
RUEHDO/AMEMBASSY DOHA 1581
RUEHLO/AMEMBASSY LONDON 9040
RUEHML/AMEMBASSY MANILA 3065
RUEHNE/AMEMBASSY NEW DELHI 3989
RUEHBUL/AMEMBASSY KABUL 9359
RUEHLH/AMCONSUL LAHORE 6305
RUEHKP/AMCONSUL KARACHI 0571
RUEHPW/AMCONSUL PESHAWAR 5150

C O N F I D E N T I A L SECTION 01 OF 04 ISLAMABAD 003532

SIPDIS

E.O. 12958: DECL: 11/07/2018

TAGS: [ECON](#) [EFIN](#) [EINV](#) [ETRD](#) [ELAB](#) [PGOV](#) [PREL](#) [PK](#)

SUBJECT: DCM MEETS WITH STATE BANK GOVERNOR AKHTAR

Classified By: Anne W. Patterson for reasons 1.4 (b), (d).

11. (C) Summary: In a November 5 meeting, State Bank of Pakistan (SBP) Governor, Dr. Shamshad Akhtar confirmed that negotiations with the IMF are stuck on the issue of how much to raise interest rates. The GOP plans to make a decision on this issue November 12. She expressed surprise on being advised that the Friends of a Democratic Pakistan is not a pledging conference. Akhtar voiced frustration about interference by Finance Advisor Tareen, President Zardari, and Zardari's corporate friends in state bank affairs. She repeated that she will leave when her term ends on December 31. End Summary.

12. (C) On November 5, DCM and ECONOffs met with State Bank of Pakistan Governor Dr. Shamshad Akhtar in Islamabad. Noting that she was in Islamabad for a few days waiting for the President to return from Saudi Arabia, she said "it is hard to say what the outcome of [his] trip will be." Akhtar was extremely candid during the free flowing conversation and expressed frustration with both the lack of attention focused on the IMF negotiations from President Zardari and the lack of willingness to negotiate on the part of the IMF.

FRIENDS OF PAKISTAN

13. (C) Akhtar noted that the next meeting by the Friends of a Democratic Pakistan (FODP) is November 17. She initially said that she hopes that Friends "come through" with donations. When the DCM replied that the FODP is not a pledging conference and "would not provide any cash infusion", Akhtar questioned, "Does the President know this? This is the first time I have heard this." The DCM explained that FODP members have been very clear in explaining this to senior GOP leadership on numerous occasions. The DCM further stated that the group is interested in supporting the long-term economic and political stability of Pakistan but is not and has never been described as a donors' conference.

IMF NEGOTIATIONS- INTEREST RATES ARE STICKING POINT

14. (C) DCM emphasized that "any solution for Pakistan rests with the IMF." Akhtar described the IMF program negotiations in Dubai as constructive and stated that "most of the issues had been thrashed out there." She noted that the key unresolved issue is how high to raise interest rates and presented five reasons why sharply raising

rates is inappropriate for Pakistan at this time.

15. (C) Akhtar noted that it is very difficult to raise rates when globally rates are being cut. She said, "it is very clear that what is going on in the region will hurt the competitiveness of Pakistan."

Akhtar then noted that "we have already raised rates" and implied that Pakistan wasn't getting credit for the previous rate adjustments on May 22, and July 19, cumulatively a 3.5 percent increase this year. She stated, "We have already done it and I hoped they would see what we have done as pre-commitment" Akhtar noted that rather than immediately raising rates, it is more appropriate to coincide an interest rate move with the release of the next semi-annual monetary policy announcements in January. At that time the SBP will review the situation and may raise rates again.

16. (C) Akhtar conceded that core inflation has been high but she believes that policy changes and the effects of lower fuel prices are now beginning to reduce inflationary pressure. She stated that "We are not disputing that core inflation has gone up," but it takes time for policy and fuel price changes to pass through. "We need to allow six months or more. In our assessment, inflation will come down." Akhtar noted that the SBP will continue to promote the tighter monetary policy it has had since 2005. She also noted that the GOP has a limited ability to curb inflation.

17. (C) Akhtar said that anything less than 600 percent of Pakistan's IMF quota was "not adequate given the situation, density and size of Pakistan's economy." Noting that if Pakistan's package is USD 9.6 billion or 600 percent of quota it would be the 'smallest by far' of the IMF packages but yet Pakistan has been "the worst hit

ISLAMABAD 00003532 002 OF 004

country." She noted that packages for other countries are substantially larger, such as USD 25 billion for Hungary and 800 percent of quota for Ukraine. Akhtar was candid in her opinion that the Deputy Director of the IMF is very biased and is trying to base these programs on his experience in Brazil. She noted that there can't be any one model and further commented that mistakes have been made in these programs in the past, giving the example of Indonesia. She also referenced her recent conversations with the state bank governor of Portugal who is allegedly frustrated with the IMF narrow-mindedness as well.

18. (C) EconCounselor asked if perhaps some clarity might be given to the interest rate issue with the IMF if there were a general government commitment to increase interest rates in January since the Governor herself hasn't been reappointed yet. Akhtar noted that she expected whomever was in office would commit to raise interest rates.

DCM asked if the IMF or the GOP were considering whether disbursements could be made in separate installments, conditional upon interest rate increases. Akhtar claimed that this had never been discussed.

19. (C) Akhtar noted general concern with the Fund's prescriptions. While discipline is needed, she said the IMF needs to have a mix of policies and should have some flexibility for trade-offs. Akhtar commented that the minutes of the IMF Board meeting on Pakistan acknowledged that this is an emergency and that IMF staff should not "kill the patient." She urged everyone to read the minutes of the board meeting where the IMF was cautioned to not impose harsh conditions but rather "this was supposed to be an owner-driven plan."

She said she told the IMF that she would comply with their requirements -- "put a gun to my head and I will raise rates" -- but that it is not in Pakistan's interests to raise rates. "I sincerely believe this is the wrong time."

POLITICAL ECONOMY SHOULD NOT BE UNDERESTIMATED

110. (C) Akhtar further noted that the political economy of Pakistan makes further rate increases very difficult. She claimed that there are serious problems with the corporate sector, who are demanding 4-5 percent reductions from the 13.5 percent rate. Noting that every day you can see another press statement from another industrial group which has met with the Prime Minister or President, Akhtar stated

"they refuse to meet with me now because they are very annoyed with my policy" to increase interest rates. While she has not been receptive to their pleas, the President and Prime Minister have been listening.

¶11. (C) Akhtar believes there is some merit to the argument that a decline in business activity would cause a reduction in exports, which would further widen the trade deficit, and require additional financing. Industry must be allowed to continue or Pakistan will see massive layoffs and unemployment. Akhtar stated that "now with energy cuts, production is hurt but manufacturing is the bread and butter of our country and we can't let exports go down." Akhtar noted the banking sector is already making significant layoffs and stated that "Price stability is important but legally I must be concerned with employment too."

THE END OF AN ERA

¶12. (C) Akhtar's term ends on December 31, 2008. She disclosed that due to problems with the President Zardari and Financial Advisor Tareen, she is not interested in reappointment and will leave by January 1. She said that "Zardari is surrounded by people with private interests," and further she noted with dismay that there are press reports indicating that she will be out by November 15. Akhtar seemed frustrated by the lack of high level focus on the IMF and noted that at one time she had a good discussion with Zardari on how to convey the right signals and that the IMF was the only true recourse. Stating "I brought the IMF to the table," she said that despite the constant discussion and public announcements of plans A, B, and C, "the government has only one plan-- to get money." "The politicians said the IMF is bad, and that interest rates are bad."

ISLAMABAD 00003532 003 OF 004

Now the corporate sector is talking about organizing protests. If you continue to play to the gallery, this is what you get."

AUTONOMY OF THE CENTRAL BANK DECLINING

¶13. (C) Akhtar was very forthright in sharing her concerns that Zardari and his financial team were moving to reduce the autonomy of the central bank. She expressed her opinion that Finance Advisor Tareen is trying to consolidate all of the control of financial matters under his authorities. Noting that the independence of the SBP has long been a bedrock in Pakistan's system under Musharraf and was recognized internationally as very strong, Akhtar was very candid in stating that "Zardari is too dependent on Tareen" and that Zardari needs to be "briefed on the dangers" of having "one advisor provide all." According to Akhtar, Tareen officially ceded control of the bank he owns to his brother but functionally still runs it. She said Tareen wants to run both the Finance Ministry and the SBP. "Somebody has to independently brief the President, because in the end he will get hurt" by biased advice.

¶14. (C) Akhtar stated "If I were at the IMF, I would have pushed for central bank independence. With independence, [rational rates] would have followed. Who can dispute central bank reform?" Akhtar noted that at present the SBP cannot impose limits on government officials borrowing from the SBP despite their claims that they will try to lower borrowing. She thought it is unfortunate that enhancing central bank autonomy was compromised early in IMF program negotiations. Akhtar said it was "squashed at the technical level." Noting that India's lack of central bank autonomy is setting a poor example, Akhtar implied that senior GOP leadership sees the Indian Prime Minister making decisions on interest rates and thinks "why not do that here too?" Akhtar claimed that she's been trying to "convey a message" to Zardari but there is a "lot of noise on the issue."

NEXT STEPS

¶15. (C) Akhtar said the government must decide what to do on

interest rates. She said they are currently in a dialogue with the corporate sector but will make a decision by November 12 on whether to request the negotiated program. No further rounds of negotiations are planned though she later noted the amount and rate of disbursement of funds still "needs to be fine tuned." The decision will have to be made after the President and his 100 person delegation return from Saudi Arabia. Negotiations are "on track except for this one item."

¶16. (C) The DCM asked if the SBP could raise the composite T-Bill rate without raising the discount rate, and whether this change can be immediately implemented. Akhtar responded, "Yes, the Finance Minister and I agree" on the need to raise T-Bill rates, independent of discount rate decisions. Akhtar noted that electricity rates will also be raised by December 31 but did not indicate the percent of increase.

CENTRAL BANK FINANCING OF DEFICIT

¶17. (C) Turning to the question of continued borrowing by the central government to finance the deficit, Akhtar said the GOP has committed that, starting in November, net borrowing over the fiscal year will be zero. She noted the GOP intends to achieve net zero borrowing on a quarterly basis, but they have already borrowed heavily between July and October. Akhtar reported that the GOP argues that the "war on terror has drained more resources than expected." Akhtar explained that the budgeted deficit was 4.7 percent of GDP but the IMF proposed 3.5 percent of GDP. The compromise was 4.3 percent of GDP if external money was obtained but now it was looking like the IMF and GOP agreed to reduce the budget deficit to 3.9 percent of GDP. However, since IMF financing cannot be used for direct budget support, other sources will be necessary to mitigate the impact of development spending reductions. "Unlimited borrowing is the root of inflation" she claimed.

ISLAMABAD 00003532 004 OF 004

FINANCIAL SECTOR STABILITY

¶18. (C) Turning to financial sector stability, Akhtar noted the SBP has set up a dialogue between bankers and brokers and "now, when margins are invoked, we will not see a rush because banks will use a one year term facility." Further, the SBP extended collateral regulations to include real estate. She acknowledged that there is still concern about the prospect of foreign portfolio investors withdrawing funds from the market and draining away exchange reserves when the floor in the Karachi Stock Exchange is removed.

¶19. (C) Akhtar said the banking sector is also being brought under pressure now. Over 145 billion rupees (USD 17.9 million at 80.9 Rupees per dollar) have been withdrawn on rumors and Akhtar expressed dismay that on rumors even the GOP withdrew funds of government-owned, public sector enterprises. "All of this was sentiment driven." Akhtar noted that she moved quickly to stabilize the situation and to mobilize deposits, including through television appeals. She said that she moved aggressively to add liquidity to the banking system. She reported that foreign exchange rates have stabilized. Akhtar expects liquidity will improve, and with a cash infusion, foreign reserves will rise.

AML/CFT

¶20. (C) When asked about the status of a terms-of-reference required to place an AML/CFT technical advisor from the USG, Akhtar said "I cleared it and told them to move it." She said that the GOP looks forward to further cooperation and she would have the terms of references forwarded immediately to the Embassy. Akhtar said that legislation to strengthen Pakistan's enforcement of AML/CFT laws has Cabinet-level approval and will go to Parliament for ratification. Akhtar thought the draft legislation had already been shared with the USG but offered to make it available immediately.

PATTERSON

H:\Econ\Macroeconomic\11-5-08 SBP Gov Meeting.doc